

# HEALTH OF HUD'S FEDERAL HOUSING ADMINISTRATION'S INSURANCE FUND

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## HEARING

BEFORE THE

### SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

OF THE

### COMMITTEE ON

## BANKING, HOUSING, AND URBAN AFFAIRS

### UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE FINANCIAL STATUS OF THE DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT'S FEDERAL HOUSING ADMINISTRATION'S MU-  
TUAL MORTGAGE INSURANCE FUND

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MARCH 19, 2001

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## HEALTH OF HUD'S FEDERAL HOUSING ADMINISTRATION'S INSURANCE FUND

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MONDAY, MARCH 19, 2001

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
SUBCOMMITTEE ON HOUSING AND TRANSPORTATION,  
*Washington, DC.*

The Subcommittee met at 1 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator Wayne Allard (Chairman of the Subcommittee) presiding.

### OPENING STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. I want to call the Subcommittee on Housing and Transportation to order. I would like to welcome each of you to this hearing of the Housing and Transportation Subcommittee. Today's hearing will focus on the health of the FHA's Mutual Mortgage Insurance Fund.

Over the last 2 years, this Subcommittee has heard various proposals to spend down the so-called FHA reserve. However, before any action is taken, Congress must establish, with the help of the General Accounting Office and other accounting experts, the safe and the adequate levels of the FHA's reserves. Only then should we address a potential surplus.

FHA provides an important program for first-time low and moderate income and minority homeowners. These families should not be overcharged FHA premiums. Premiums in excess of an amount necessary to maintain an actuarially sound reserve ratio in the FHA's Mutual Mortgage Insurance Fund can only be characterized as a tax on homeownership.

On the other hand, Congress, in conjunction with the Department of Housing and Urban Development, must ensure that FHA stays healthy, so that it can continue to function as an important source of homeownership.

Congress has previously determined that a capital reserve ratio of 2 percent of the MMI Fund's amortized insurance-in-force is necessary to ensure the safety and the soundness of the MMI Fund. However, it has never been clear how the Congress arrived at that number.

Last year, the accounting firm of Deloitte & Touche found that the capital adequacy ratio of the Fund was 3.66 percent, far in excess of the Congressionally mandated goal of 2 percent. So while it is important for Congress to know the capital adequacy ratio, it is just as important to understand the implications of the ratio and whether a 2 percent reserve is sufficient.

In order to get a better handle on this issue, I requested that the GAO look into the matter. Today, the GAO is releasing a report that finds the current reserve is adequate to withstand all but the most serious economic scenarios. However, GAO also sounds a note of caution. Economic conditions can quickly change, thus changing the value of the Fund and the level of the reserve.

I believe that the most prudent course of action is for the Congress to increase the reserve requirement to either 2.5 percent or 3 percent of the insurance-in-force and then direct the Department to reinstate distributive shares whenever the reserve fund becomes excessive.

Later this week, I will be introducing legislation that would require partial rebates of FHA's mortgage insurance premiums to certain mortgagors upon repayment of their FHA-insured mortgages. My legislation takes the cautious approach of providing rebates only when the reserve ratio is in excess of 3 percent, or 150 percent of the reserve level mandated by Congress. If the reserve ratio drops below 3 percent, distributive shares would be suspended. Of course, this rebate would be based on sound actuarial and accounting practice, since the major reason for the strength in the Fund is the fact that we are experienced a near-perfect economy in recent years.

The FHA's single-family mortgage program was designed to operate as a mutual insurance program where the homeowners were granted rebates on excess of premiums required to maintain actuarial soundness. This rebate program was suspended at the direction of Congress in 1990, when the MMI Fund was in the red, and with the intent that the payment of distributive shares or rebates would resume when the Fund was again financially sound.

With a sufficient capital reserve ratio, it is time to resume rebates and return the MMI program to its prior status as a mutual insurance fund.

Our witnesses today will be Mr. Thomas McCool, Managing Director of the Financial Markets and Community Investment Team at the U.S. General Accounting Office. Mr. McCool is accompanied by Jay Cherlow, Christine Bonham, Mathew Scire, and Stanley Czerwinski.

Welcome.

It is good to see you again, Stan. I look forward to hearing from all of you.

We will go ahead and ask if there are any other statements from Members of the Subcommittee.

Senator Reed.

#### **OPENING COMMENTS OF SENATOR JACK REED**

Senator REED. Thank you very much, Mr. Chairman. I am looking forward to working with you on this issue and a number of other issues as we go forward with this Subcommittee.

Gentlemen, thank you also for being here today as witnesses.

The FHA's Mutual Mortgage Insurance Fund has proven to be very robust over the last several years. It is a source of support for the housing sector of our economy. Indeed, the FHA's insurance loans go to first-time homebuyers, primarily, and also significantly

help minority communities, African-Americans and Hispanics, to be homeowners. All of these are very laudatory.

One interesting aspect of the present economy is the fact that so many communities are facing a shortage of affordable, decent housing, and we are all trying to find ways in which we can increase the housing stock. The FHA's reserve fund might provide such a mechanism.

As you know, and as the Chairman explained, you have looked closely at the reserve fund. It is required to maintain a 2-percent capital ratio. It is doing quite a bit better than that at the moment. It is somewhere between 3.2 percent, your estimate, and 3.66 percent, the Deloitte & Touche estimate. This is a good sign. Now the question is, what can we do with this excess surplus, if you will.

As you know, many Senators, including Senator Kerry, Senator Sarbanes, and myself have urged that we take a portion of this reserve and use it to capitalize an Affordable Housing Trust Fund for building both rental and homeownership housing. And given what I see in my State of the dire need for affordable, decent housing, I think that is a very important priority which we should support.

My colleague, Senator Allard, has just explained his proposal to rebate premiums.

I look forward to the testimony today, not only to examine the soundness of the Fund, but also to be more fully informed about the possible use of its proceeds.

I thank the Chairman for calling this hearing.

Senator ALLARD. Thank you.

Senator Corzine.

#### **OPENING COMMENTS OF SENATOR JON S. CORZINE**

Senator CORZINE. Thank you, Mr. Chairman.

Mr. McCool, I appreciate you and your staff joining us. This is an issue I have a great interest in, mainly along the lines that Senator Reed talked about.

Affordable housing in New Jersey is one of the most important topics on our agenda, and certainly, we would like to understand the potential use of the Fund for that purpose.

But I would also make the other observation that we have come through a decade of robust economic times and we are now facing something that may be slightly more discouraging. One wonders about the adequacy of a Fund under different circumstances. I certainly want to hear your views with regard to it.

I look forward to the discussions at this hearing and going forward, and I thank you for having this hearing, Mr. Chairman.

Senator REED. Mr. Chairman, may I make one amendment to my statement?

Senator ALLARD. Yes, you may.

Senator REED. I greeted the gentlemen, which is testimony to my poor peripheral vision.

[Laughter.]

Welcome, Ms. Bonham.

[Laughter.]

Senator ALLARD. We will go ahead and start the panel.

Mr. McCool, it is my understanding that you are going to give the testimony this morning.

**OPENING STATEMENT OF THOMAS J. McCOOL  
MANAGING DIRECTOR  
FINANCIAL MARKETS AND COMMUNITY INVESTMENT  
U.S. GENERAL ACCOUNTING OFFICE  
ACCOMPANIED BY: MATHEW SCIRE, STANLEY CZERWINSKI,  
JAY CHERLOW, AND CHRISTINE BONHAM**

Mr. McCOOL. Mr. Chairman, Members of the Subcommittee, we are here today to discuss the results of our analysis of the financial health of the Mutual Mortgage Insurance Fund of the Department of Housing and Urban Development's Federal Housing Administration. Through the MMI Fund, the FHA operates a single-family insurance program that helps millions of Americans buy homes, particularly low-income families and those without cash for down payments.

For most of its history, the Fund was relatively healthy; however, in fiscal year 1990 the Fund was estimated to have a negative economic value, and its future was in doubt. To help place the Fund on a financially sound basis, Congress enacted legislation that required the Secretary of HUD to, among other things, take steps to achieve a capital ratio of 2 percent by November 2000, and to maintain or exceed that ratio at all times thereafter. As a result of the 1990 housing reforms, the Fund must not only meet capital ratio requirements, it must also achieve actuarial soundness; that is, the Fund must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on foreclosed mortgages and administrative costs. However, the legislation does not define actuarial soundness.

The 1990 FHA reforms required that an independent contractor conduct an annual actuarial review of the Fund. These reviews have shown that during the 1990's, the estimated economic value of the Fund, its capital resources plus the net present value of future cash flows, grew substantially. You can see by the chart in my prepared statement that by the end of fiscal year 1995, the Fund attained an estimated economic value that slightly exceeded the amount required for the 2-percent capital ratio. The gray represents 2 percent of the unamortized insurance-in-force and the white represents the value of the Fund.

Since that time, the estimated economic value of the Fund continued to grow and always exceeded the amount required for a 2-percent capital ratio. In the most recent review, Deloitte & Touche estimated the Fund's economic value at about \$17 billion at the end of fiscal year 2000. This represents about 3.51 percent of the Fund's insurance-in-force.

Mr. Chairman, you asked us to estimate the value of the Fund at the end of fiscal year 1999, given expected economic conditions, and compare our estimate to the estimate of the value of the Fund reported by HUD for that year. Also, to determine the extent to which a 2-percent capital ratio would allow the Fund to withstand worse-than-expected economic conditions and resulting loan performance. And also, to describe some options for adjusting the size of the Fund if the estimated capital ratio is different from the amount needed and required.

In summary: First, we estimate that the Fund had an economic value of approximately \$15.8 billion at the end of fiscal year 1999.



And this estimate implies a capital ratio of 3.2 percent of the unamortized insurance-in-force. Although we did not evaluate the quality of Deloitte's estimates, which were prepared using a different method of analysis, we believe that our results and theirs are comparable because of the uncertainty inherent in forecasting and the professional judgments made in this type of analysis.

Second, given the economic value of the Fund and the state of the economy at the end of fiscal year 1999, a 2 percent capital ratio appears sufficient to withstand moderately severe economic downturns that could lead to worse-than-expected loan performance. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, there were certain more severe scenarios in which an economic value of 2 percent of insurance-in-force would not have been adequate. Nonetheless, because of the nature of such analysis, we urge caution in concluding that the estimated value of the Fund today implies that the Fund would necessarily withstand any particular economic scenario under all circumstances.

The third point, Congress and the Secretary of HUD have taken and could take a number of steps to influence the economic value of the Fund. The impact that these actions have on the capital ratio and FHA borrowers is not always certain. However, actions that influence the Fund's reserve levels will also affect the Federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, will result in a decline in the Federal budget surplus.

I am going to go through the three parts of our report.

First, I am going to spend just a little bit of time talking about our estimate of the value of the Fund and the comparison with the Deloitte estimate.

The economic value of the Fund consists of current capital resources and the net present value of future cash flows. Investments in nonmarketable Treasury securities represent the largest component of FHA's current capital resources. Estimating the net present value of future cash flows is a complex actuarial exercise that required extensive professional judgment. Cash flows into the Fund from premiums and the sale of foreclosed properties; cash flows out of the Fund to pay claims on foreclosed mortgages, premium refunds, and administrative expenses.

If you look at the chart,\* you can see the inflows again from premiums and sale of properties and the flows out of the Fund from paying claims on foreclosed mortgages and premium refunds and administrative expenses.

At the end of the fiscal year 1999, the Fund had capital resources of \$14.3 billion. Using our models and forecasts of likely values of economic variables, we estimated that the Fund had a net present value of future cash flows of \$1.5 billion at that time. This yielded an estimated economic value of \$15.8 billion and a capital ratio of 3.2 percent.

Now these are a little bit different than the numbers for 1999 that Deloitte came up with. And the primary source of the difference had to do with the timing of the estimates. Deloitte had to

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\*Attached to prepared statement.

do its estimate before the end of the fiscal year and we were able to do ours after the fact, so we had a more accurate count of the capital resources, whereas, Deloitte overestimated the capital resources by about a billion dollars. Again, part of that just reflects the difference in the time when Deloitte had to do its estimate versus when we did ours.

The Fund's economic value principally reflects the large amount of capital resources that the Fund has accrued. These result from previous cash flows that reflect the robustness of the economy, the low-interest rates and high levels of employment usually associated with high levels of mortgage activity, along with higher premium rates throughout the 1990's.

The estimated value of future cash flows also contributed to the strength of the Fund at the end of fiscal 1999, and in addition, forecasts for the near future show rising housing prices and stable interest rates. As a result, our models predict low levels of foreclosure and prepayment and a cash flow into the Fund from mortgages already in FHA's portfolio at the end of the 1999 fiscal year will be more than sufficient to cover the cash outflows associated with these loans.

Now, again, that is a static estimate. It is just a comparison between Deloitte's and our estimate.

I think the more substantive part of our analysis had to do with trying to understand this issue of actuarial soundness.

To provide a framework within which actuarial soundness could be assessed, we need to move beyond estimates of the capital ratio under expected economic conditions. Instead, we believe that to determine actuarial soundness one should measure the Fund's ability to withstand worse-than-expected conditions, although how much worse is a more difficult judgment.

We generated economic scenarios that were based on economic events in the last 25 years. In addition, we generated other scenarios that lead to worse-than-expected levels of performance in the future. Using the actual historical scenarios, we found that the effect on the Fund's estimated value was actually fairly minimal. The worst historical scenario we tested, which was based on the 1981-1982 national recession, lowered the capital ratio by less than four-tenths of a percentage point, from about 3.2 to about 2.8 percent. To see how the economic value of the Fund would change as the extent of adversity increased, we extended regional scenarios that were based on historical economic downturns to the Nation as a whole.

We extended the west south central and pacific downturns which reduced the capital ratio by about 1 percentage point and then we extended the New England downturn to the country as a whole, and that reduced the capital ratio by about 2.4 percentage points, so from about 3.2 to about 0.8.

In another scenario, we specified falling interest rates that would induce refinancing, followed by a recession. And again, in this particular scenario, we estimated that the capital ratio of the Fund would be reduced from 3.2 to about 1.4 percent.

Again, these are all different sets of scenarios, some of them more likely than others, obviously. But the idea here is to try to see what kind of a stress it might take to actually reduce the Fund

by either 3 percent or 2 percent or 1 percent, whatever the particular level you are trying to test.

Now, because we are starting from a position where the economy is doing very well and the recent historical experience has been very good, we were not able to generate, using our economic models, foreclosure rates that were in keeping with those that were experienced in the 1980's. We wanted to see just how the Fund would withstand such foreclosure rates.

So we tried some alternative scenarios, one in which we actually imposed foreclosure rates that were experienced in the years 1986 through 1990, for the years 2000 through 2004. When we did this—these again were historical foreclosure rates, they just did not flow from our economic model, per se—we found that the ratio, the capital ratio, would fall from about 3.2 to about 0.9 percent. Again, that is a fall of over 2 percentage points.

An alternative exercise which we did—again, it is not so much a stress test as it is kind of a sensitivity analysis—was to see what would be the effect of extending certain experience to a larger part of the FHA's portfolio. We used the southwestern experience, which actually affected about 9 percent of FHA's portfolio, and we extended it to larger and larger parts of their portfolio to see how large an effect it would take to actually reduce the capital ratio by 2 percent or reduce it, in fact, to zero, in one extreme case.

As you can see from the graph,\* if 36 percent of the FHA's portfolio experienced foreclosure rates similar to those in the southwest in the late 1980's, that would bring the estimated capital ratio down to about 1 percent. If 55 percent of the portfolio experienced such foreclosure rates, that would actually bring the estimated capital ratio down to zero.

Again, that does not mean that these are likely events. Our analysis is just an attempt to show how large an effect you would need in order to generate a certain result.

Now, while we believe that our models make good use of historical experience in identifying factors that influence foreclosures and prepayments, we also know that there are certain limitations.

Nonetheless, several additional factors lead us to believe that Congress and others should apply caution in concluding that the estimated value of the Fund today implies that the Fund could withstand the economic scenarios that we examined under all circumstances.

In particular, the performance of our model is very dependent on the fact that a lot of the loans were originated in the fiscal years 1998 and 1999. And as a result, the performance of these loans will have an important effect on the overall performance of the loan portfolio, but we don't have a lot of experience with these loans. They are, obviously, 1 or 2 or 3 years old. As long as the influences of key predictive factors on the probabilities of foreclosure and prepayment have not changed, then we can be reasonably confident the estimates of the relationships will apply. However, in recent years, FHA's competitors in the conventional mortgage market are offering to selected homebuyers products that compete with FHA

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\*Attached to prepared statement.

for those homebuyers who are borrowing more than 95 percent of the value of their homes.

If these private-sector competitors have attracted some less risky borrowers who might otherwise have insured their mortgages with the FHA, then the average risk level of FHA's loans may have increased. Again, we don't know that is true. That is just one possibility, which would imply that we might be under-predicting foreclosures in our current model.

It is also true that there have been changes in FHA's insurance program. A number of changes that FHA has made or might make in the future could affect the future cash flows associated with loans in FHA's portfolio. FHA's loss mitigation program might affect cash outflows, depending on whether the program succeeds in reducing foreclosures or whether the program may result in delayed foreclosures that lead to larger losses. We don't know the answer. We just know that this is one thing that has changed and therefore could change our model's predictions in the future. Also, steps taken by HUD to improve the oversight of lenders and the disposition of properties could reduce the level of losses to FHA below what we have estimated.

In addition, as we are talking about the existing portfolio at the end of 1999, we don't know what is going to happen with new loans, either loans that are made in 2000 or loans that are made in 2001, or those loans made going forward. Our analysis of the ability of the Fund to withstand adverse economic conditions requires making the assumption that the adverse conditions would not also cause loans insured by FHA after fiscal year 1999 to be an economic drain on the Fund. And that is again just one of the assumptions we had to make in doing our analysis.

Now, I would like to turn to the last issue which has to do with discussing options for drawing on the Fund, which have uncertain outcomes, obviously. If Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to ensure actuarial soundness, several changes to the FHA's single-family loan program could be adopted. The impact that these actions might have on the capital ratio and FHA's borrowers is difficult to assess without using tools designed to estimate the multiple impacts that policy changes often have.

Although it is difficult to predict the overall impact of a change on the Fund's capital ratio and thus on FHA borrowers as a whole, different options would likely have different impacts on current and prospective FHA-insured borrowers. Some proposals would more likely benefit existing and future FHA-insured borrowers, while others would benefit only future borrowers, and still others would benefit neither of these groups.

Because of the difficulty in reliably measuring the effect of most actions that could be taken either by Congress or by the Secretary of HUD on the Fund's capital ratio, we cannot precisely measure the effect of these policies on the budget. However, any actions taken by Congress or the Secretary that influence the Fund's capital ratio will have a similar effect on the budget.

Last, I want to just talk a little bit about actuarial soundness and what it means, and what it doesn't mean.

Whether actions should be taken to change the value of the Fund depends on whether the Fund's capital resources and expected revenues exceed the amount needed to meet its expected cash outflows under designated stressful conditions; that is, whether it is actuarially sound. Assessing whether this condition exists requires that the degree of risk the Fund's expected to be able to withstand must be specified. If the Fund is expected to withstand what Price Waterhouse calls reasonably adverse economic downturns, then our results could be construed to mean that the Fund is taking in more revenue than it needs. Alternatively, if the Fund is expected to never exhaust its resources or to be able to withstand stresses such as the Great Depression, the current Fund might not be adequate.

Because we believe that actuarial soundness depends on a variety of factors that could vary over time, we also believe that a minimum or target capital ratio won't necessarily guarantee that the Fund will be actuarially sound over time. We believe that to evaluate the actuarial soundness of the Fund, one or more scenarios that the Fund is to withstand would need to be specified. Then it would be appropriate to calculate the economic value of the Fund under the scenarios. As long as the estimated economic value is positive and the desired stress scenario is used to make that estimate, the Fund could be said to be actuarially sound. However, it might be appropriate to leave a cushion to account for the factors not captured by the model and the inherent uncertainty attached to any forecast. In any event, we believe that a single, static capital ratio does not necessarily measure actuarial soundness.

For these reasons, Mr. Chairman, Congress may wish to consider taking action to specify criteria for determining when the Fund is actuarially sound. Specifically, the Congress may want to consider defining the types of economic conditions under which the Fund would be expected to meet its commitments without borrowing from the Treasury.

Mr. Chairman, this concludes my statement. We would be happy to answer any questions that you or any other Members of the Subcommittee might have.

Senator ALLARD. Thank you very much. I thought that was a very good statement you made and I want to thank you for your efforts and diligence in putting together this report.

Just for Members of the Subcommittee, we have 5 minutes per Member. We have a small clock down here. It is a little difficult to read, but when the light starts turning orange, you have a minute left. When it is green you are okay. And when it is red, we ask that you stop.

I want to start out with just where we are today.

My memory recalls that back in 1979 or so, we had a reserve in the Fund of about 5.3 percent. Frankly, it is quite a bit higher than what we are having today. But then in 1990, about 11 years later, we are running into some deficits in the Fund. Would you explain briefly why this should or should not be a concern for us today?

Mr. MCCOOL. Well, I think that it both should and should not be a concern. Again, part of it is that the Fund was run down over a 10-year period and it had to do with the sequence of economic factors. It had to do with very high interest rates in the early 1980's and a recession in the early 1980's, followed by a number

of regional downturns. You have high regional unemployment rates, much higher average unemployment rates for the economy as a whole than you currently have. So, again, you can find a high ratio turn into a lower or negative ratio over time if you get the right sequence or concurrence of events. But it is also true that the 1980's in particular were different than the 1990's have been, in terms of things like interest rates and unemployment rates, and at least so far in terms of housing price changes.

Senator ALLARD. Probably the increase in interest rates had as much to do with anybody as to help assure the——

Mr. MCCOOL. The early 1980's interest rates had a lot to do with the later 1980's performance, yes.

Senator ALLARD. Last week, the Mortgage Bankers of America released data showing that the delinquency rates on FHA loans is now 10.46 percent, about 10½ percent, which is well over three times the conventional rate of about 3 percent.

In my first hearing, I think, as Subcommittee Chairman, we looked at those delinquency rates 2 years ago. At that time, we were alarmed that the delinquency rate was 8.45 percent and that our ARM's, the delinquency rate was 10.46 percent. Two years later, both of those figures have gone up, I think, rather substantially to 10½ percent and 12 percent, respectively, where the ARM's are 12 percent and the regular loans are at 10½ percent. The trend is now upward and we are still in a relatively healthy housing market, at least in Colorado.

What happens in a recession? At what point should we become concerned that this could threaten the FHA Fund's actuarial soundness?

Mr. MCCOOL. In particular, in a recession that causes a substantial increase in unemployment rates and either a flat or potentially a reduction in housing prices, you can get increases in foreclosures and delinquencies. And that can have an effect on FHA. It depends a lot on how severe the recession is, how long it lasts, as to how much an effect it will have.

Senator ALLARD. Which is obviously what has been happening even before we were in any kind of an economic downturn, with these figures that we are looking at.

Mr. MCCOOL. It is hard to predict and it is hard to—that may be true. But we also have to be a little careful about changes in delinquency rates on average because part of it can also reflect just sort of an aging of the portfolio.

Senator ALLARD. Yes.

Mr. MCCOOL. You did have a lot of new loans in the portfolio and generally, new loans don't default. It usually takes a few years before they reach the default stage. So it could also just be a question of some of those loans moving into the peak years for defaults; you need to look at the loans on a cohort-by-cohort basis to see if default rates are really necessarily increasing.

Senator ALLARD. When we talked about the high delinquency rates on the ARM's, Mr. Apgar testified in front of our Committee at that time and he indicated that they can deal with the problem. Have you seen any evidence that would indicate they have taken any kind of action on this particular issue when you did your audit?

Mr. MCCOOL. Stan handled that.

Senator ALLARD. Mr. Czerwinski, maybe you can answer that.

Mr. CZERWINSKI. I remember that hearing very well. We talked about how ARM's were very sensitive to interest rates. Interest rates were probably one of the key problems in the 1980's. ARM's combined with interest rates was one of the key problems with FHA. And as Tom mentioned, it is an aging of the portfolio that is an issue.

Mr. Apgar promised to reduce the number of ARM's and put stricter underwriting standards in place, which they have done. If you look at the current portfolio and what is being written now, there are much fewer ARM's. That is the good news.

I think probably what you were picking up in the delinquency rates now is that some of these ARM's from the past are aging a bit. Interest rates have been coming up. So, we still have to work our way through some of the past policies. But I don't think you will be seeing that as much in the future.

There is one other issue lurking out there, and that is called streamlined refinancing. That is rolling over mortgages. And the way FHA has been doing it is to do it without that much underwriting requirements. That is the next issue that is waiting.

We talked about ARM's in 1998. In 2001, we are now saying, gee, what happened with ARM's? My guess is we may be talking in 2003 about streamlined refinancing.

Senator ALLARD. Thank you.

I will now go to my Ranking Member, Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Thank you very much, Mr. McCool, for your testimony.

Is it fair to say that the FHA Fund is performing very well when tested against all of your scenarios, that essentially, it is in good shape?

Mr. MCCOOL. In the sense that at least none of our economic scenarios brought it down to zero; the Fund still had a positive value, even in our more stringent scenarios. So in that sense, yes.

Senator REED. And you used foreclosure rates from the 1980's, which were very severe foreclosure rates.

Mr. MCCOOL. In the one scenario, yes. We used foreclosure rates from the 1986 through 1990 period, which were the steepest, the worst we have seen in the post-war period, yes.

Senator REED. That is really the most extreme test you could apply, in terms of foreclosure rates.

Mr. MCCOOL. Again, given what we have seen in the post-war period, yes.

Senator REED. And still, the Fund was able to maintain a very positive—

Mr. MCCOOL. It still had a 0.9-percent capital ratio.

Senator REED. In your scenarios generally, the assumption I think, and this might just be the limitations of modeling, is that the FHA managers really can't respond to changes in the economy with preventive action or new policies. Is that fair to say?

Mr. MCCOOL. It is fair to say. But it is also true that we are looking at a portfolio that is under contract. There is only so many things that the FHA can do with those.

Senator REED. Right.

Mr. MCCOOL. They can do more with new business than they can with existing business.

Senator REED. But in terms of getting out of a precipitous decline, trying to get to at least a plateau with new business, you can make some policy changes that would presumably help.

Mr. MCCOOL. You can mitigate it, sure.

Senator REED. That is something that I suspect, given the limitations of the modeling, that you can't model particularly well.

Mr. MCCOOL. No, we were not modeling that at all in our particular scenario.

Senator REED. Let me ask again a question about both your model and the FHA portfolio. Is there any regional bias in terms of the number of, the concentration of loans, in one particular geographic region?

Mr. MCCOOL. I think it is the regional bias of the FHA portfolio.

Mr. CHERLOW. I don't know if you could call it a bias. But certainly, in certain parts of the country, FHA has a larger market share than in other parts of the country.

Senator REED. Right. A regional downturn in those areas would have a more traumatic effect on the Fund than other areas. Is that correct?

Mr. CHERLOW. That is right.

Senator REED. And your model compensated for the geographic specificity?

Mr. CHERLOW. Our model weights the loans from each region according to the share that they are in FHA's portfolio.

Senator ALLARD. Where do you have those larger number? Where do we have the larger number of FHA loans? Can you comment on that?

Mr. CHERLOW. Yes, sir. California, Texas, Florida. Those are the three largest States.

Senator REED. California, Texas, Florida. California is enduring some unusual problems right now in terms of an energy crisis, etc. So that that might be sort of a caution to the Fund managers.

You tested 2 percent as a capital ratio, Mr. McCool. There has been discussions about legislation that would increase the statutory level to 3 percent and then use funds above and beyond that for other purposes. Putting aside the purposes, is that 3-percent capital ratio level significantly high enough, given the fact that the 2 percent level seems to have survived all these various tasks?

Mr. MCCOOL. Again, it depends on what you are trying to protect the Fund against. From our analysis, 3 percent would be better to protect it against, again, the more extreme scenarios, some of which did lower the Fund by more than 2 percentage points.

Senator REED. If the Fund is reduced to 0.9 percent, which is your worst-case scenario, would you deem the Fund to be in extremis and something that is at risk? Or is that at a level sufficient to operate?

Mr. MCCOOL. It still obviously is solvent.

Senator REED. Right.

Mr. MCCOOL. The question is, what happens next? Do you have an additional negative shock? And you could be in more trouble. If you have positive shocks, then you might be back over 2 percent again. So it depends on what happens next.



Senator REED. But I guess, for the record, 3 percent is better than 2 percent, and 2 percent is okay.

Mr. MCCOOL. Three percent is safer than 2 percent.

Senator REED. Okay.

Mr. MCCOOL. I would definitely say that.

Senator REED. I am not going to get into your modeling because I am exhausted my modeling knowledge. Is there a comparable private-sector institution that we can look to for guidance regarding a loan loss reserve level? And what might that be?

Mr. MCCOOL. There are a number of alternative ways of thinking about capital ratios. There are bank capital ratios where the regulators impose credit-based capital standards.

There is, again, not quite private sector, but almost fully private sector capital regulations that OFHEO, imposes on Fannie Mae and Freddie Mac. And there is the rating agencies also that impose their own implicit capital standards on those they rate, asking again for much higher capital ratio for a triple A rating than for a double A rating and for a single A rating.

There are many different ways that people think about what kind of capital reserves you need, depending on risk and how you want to measure that risk.

Senator REED. In a nutshell, how would this 2 percent statutory level rate with those?

Mr. MCCOOL. Well, it is certainly simpler. And it is not clear how risk-based it is. I guess that would be the simple answer.

Senator REED. Thank you very much, Mr. McCool.

Thank you, Mr. Chairman.

Senator ALLARD. The Senator from New Jersey.

Senator CORZINE. Thank you, Mr. Chairman.

Pursuing that just a little bit more, Fannie Mae has a risk-based system, I presume, that is much more complicated. But if my memory serves me correct, it is something like 4 percent, if I am not mistaken.

Mr. MCCOOL. Again, there are two different issues. Fannie Mae and Freddie Mac have their own modeling approaches and then OFHEO, who is their regulator, is to impose a new statutory requirement once their role is cleared by OMB, which hasn't actually happened yet.

Senator CORZINE. Right.

Mr. MCCOOL. But I do not actually know what their rule will impose on Fannie Mae and Freddie Mac. They have statutory requirements that are minimum capital requirements that depend on whether something is off balance sheet or on balance sheet. I think it is 2½ percent for on balance sheet and 0.45 percent for off balance sheet, if my memory serves me correctly. Those are not risk-based. Those are just leverage-based.

Senator CORZINE. Right. Has there been any attempt by either yourselves or others to rate or a proxy rating, what the Fund would be rated if it were going to outside private entities?

Mr. MCCOOL. We certainly have not, and I do not know that anyone else has.

Mr. CHERLOW. Not that I am aware of, sir.

Senator CORZINE. And one of the best tests, at least in the experience I have had, is looking at secondary market spreads on what

packages of FHA, which, I guess, is in Ginnie Mae format. Have these spreads widened or tightened? Do you follow those through time and seeing whether there is a risk premium that is growing or shrinking?

Mr. MCCOOL. I have not really looked at any trends in those, no.

Senator CORZINE. Actually, it might be an interesting phenomenon. It tends to track at least how the marketplace in general is looking at it.

I was going to ask some of these regional concentration questions. They tend to be the most important in some of the valuing of the credit proportions.

Is there a statutory requirement to be at 2 percent? And what are the timeframes that surround when you are out of it and you have to get back into it?

Mr. MCCOOL. The statutory requirement is that the ratio be above 2 percent.

Senator CORZINE. Okay.

Mr. MCCOOL. I am not sure it goes much beyond that in terms of specifying what happens if you do not meet that, other than, again, things like restricting the Secretary from instituting distributive shares or things like that. But there is no real enforcement tools, I don't think.

Mr. SCIRE. The statutory requirement is a minimum capital ratio. And that was put in in the 1990 reforms. The deadline was to reach the 2 percent level by 2000.

Actually, they met the capital ratio well before 2000. But it is a minimum capital requirement. The law does not specify or define actuarial soundness, which is a trigger for certain things that the Secretary can do, such as paying distributive shares, which the 1990 reforms discontinued.

Senator CORZINE. A larger risk of default with higher loans than smaller loan portfolio?

Mr. CHERLOW. Do you mean larger loans or larger loan-to-value ratios?

Senator CORZINE. Larger loans. Just the larger end of the spectrum of your mortgages.

Mr. CHERLOW. Not generally. In fact, at times it appeared that the smallest of the FHA loans were the ones that had the largest risk of default, the very small ones.

But loan-to-value ratio is very important, those loans where the borrower is borrowing a larger share of the purchase price and therefore, has lower equity. Those tend to be more risky.

Senator CORZINE. Do you all have statistics built into your model with regard to those kinds of matters?

Mr. CHERLOW. That is right. The model takes into account loan size and loan-to-value ratio, as well as other variables.

Senator ALLARD. I think a key question for me as we look at legislation is whether the 2 percent reserve should be increased to 2.5 or 3 percent. Frankly, I feel like we need to be conservative. I don't think we need to be ridiculous about it. But I do think that we need to err on the conservative side.

There are two scenarios that you had that indicated that there would be an increased risk to the Fund. And I might just talk about those two briefly.

The first one, you described a situation where mortgage interest rates are falling, which is happening right now. And I know that there is an awful lot of refinancing going on in my State. I assume that is happening nationwide because of the drop in interest rates. I think it is a big inducement for borrowers to continue to go into kind of a refinancing mode.

In your scenario, you describe that then a recession sets in. And there is kind of a familiar ring to that. Our economy is heading down right now. And under that scenario, you say that we totally eliminate the 2 percent reserve, or near total elimination. Is it not possible that we may be entering into that situation right now?

Mr. MCCOOL. I think it would depend very much on how large and how long a recession we had.

Senator ALLARD. Yes.

Mr. MCCOOL. I am not actually sure about how big the recession was that we stressed this system with.

Mr. CHERLOW. The recession we modeled has a fairly substantial decline in house prices. Really the most critical factor is whether or not people find themselves in a negative equity position.

Senator ALLARD. Which is not happening right now, at least not in my State.

Mr. CHERLOW. Yes.

Senator ALLARD. I do not know about other States. Did you get any feel for that?

Mr. CHERLOW. No, sir, not yet.

Senator ALLARD. Second, you had a scenario which was discussed a little bit by my colleague about the foreclosure rates from the 1980's being duplicated. That was that 5-year period. Now, you described that more than wiped out the 2 percent reserve. That is a scenario that has happened within the past 25 years. It seems to me that we want a reserve that will at least sustain us through a period, one that we have experienced in recent history. Would you comment on that further?

Mr. MCCOOL. Again, as we have been saying, to a large extent, it is up to Congress to decide what stress they want the Fund to be able to undergo. It could be a mild stress or a stress like the Great Depression. And each one gives you a different potential capital ratio or relationship between risk and capital, depending on how you want to specify it.

Senator ALLARD. You also mentioned the private sector out there. They will go and rate soundness, AAA, AA, and A. If you were to rate this, where would you rate it?

Mr. MCCOOL. Well, we are not in the rating business.

[Laughter.]

It is a little hard for us to do that.

Senator ALLARD. Is there anything we can learn from the safety and soundness requirements imposed on banks with the FDIC?

Mr. MCCOOL. As I said, part of it depends on what you are trying to achieve. The banks' capital ratios basically are effectively 8 percent. But they depend a lot on the extent of credit risk that is associated with a particular type of asset. And we know that the bank supervisors are undertaking to change those standards because they think the current standards are too simple and they generate

certain types of perverse behavior. So, they are trying to move to a system that, again, matches capital more with risk.

Now, again, the other financial institution supervisory model that has similarities to the stress test we have been talking about is the OFHEO stress test for Fannie Mae and Freddie Mac. That involves a very substantial credit stress, as well as a very, very large interest rate stress. So, in some ways, it is similar to some of the stresses we did, but it also has alternative or additional stress factors.

Senator ALLARD. And their standard was not just to be conservative, but it was almost to the point where it was a catastrophic situation. Am I correct?

Mr. MCCOOL. That is certainly how Fannie Mae and Freddie Mac characterize it.

Senator ALLARD. Yes. Actually, private mortgage insurers also.

Mr. MCCOOL. Right.

Senator ALLARD. They are required by law to hold reserves that are in the catastrophic. All we are asking here is just that we be very conservative. At least that is kind of been my position.

I guess the fundamental question is why should FHA be different? Why should the standard for actuarial soundness be lower for a public fund than for a private fund, for example?

Mr. MCCOOL. Part of it does depend on FHA's role compared with the private sector. FHA does have a role to be in the market when others pull out. That is what the private sector can do. If things get tough, the private sector can decide not to play. FHA is supposed to be there to play. Plus the fact is that FHA is backed by the Federal Government. So it does have that backstop, which the private sector does not have. There are similarities, but there are also, I think, some differences.

Senator ALLARD. Thank you.

I am going to call on my colleague from Rhode Island now.

Senator REED. Thank you, Mr. Chairman.

Let's go back to the 1980's. Nostalgia calls. As I recall, it wasn't just poor economic conditions, but some negligence, if not worse, in appraising of properties and lending, et cetera, that helped with that precipitous decline. And I note that KPMG has just finished an audit contracted by HUD's Inspector General that cites improvements in FHA's oversight of lenders and appraisers.

Have you built that into the model going forward, the improvement in these oversight measures? One would hope that the Fund could now withstand more, and not be in the position that it was in the 1980's?

Mr. CHERLOW. One factor that is definitely built in, Senator, has to do with what is called the loss rate or the amount that FHA loses on each property, what percentage of the claim value does it not get back when it sells the property.

When GAO first began doing this type of work around 1990, it was common for the loss rate to be higher—I think we were using in those days 42 percent. Nowadays, I think it is more like 35 percent. So, in fact, one of the differences between the 1980's and now is that FHA has succeeded in reducing its loss rate a fair amount.

Senator REED. Thank you. In your report, you suggest that the Secretary of HUD should develop better tools for assessing the im-

pacts that policy changes will have on the volume and riskiness of the loans that it insures. And since we are all contemplating policy changes here, what are those tools? Might you be more specific?

Mr. MCCOOL. Well, I think there are a number of possible tools.

One of the things that we were suggesting was to try to come up with a better sense of how changes, in particular, in premia and other financial attributes of FHA, affect the demand for FHA loans.

For example, there is this issue about what would happen if you were to raise or lower premiums. And again, right now, there is a simple presumption that the level of FHA lending either stays the same or increases or decreases in the same proportion as the rest of the market does, which is the current demand model that Deloitte & Touche uses.

What we think would be better would be to get a sense of, if you change premiums, since you are competing with alternatives such as the conventional market, what would be the effect on the relative size of FHA compared with the rest of the market? In particular, what might be the effect on the risk characteristics of that piece that the FHA gets, to be able to truly understand the effect of a change in policy.

Senator REED. Thank you.

Deloitte & Touche has done their actuarial study. You have done your study. You cited that their study is comparable. What does that mean?

Mr. MCCOOL. What we mean is the results are comparable. We did not really do an analysis of Deloitte & Touche methodology. That was not what we were attempting to do. Also, our model was built to some extent for a different purpose than theirs. We were trying not to get into comparing our model to theirs in the sense of the mechanics of it. We were just saying that the results we came out with in measuring the Fund and the capital ratio were, we thought, similar to what Deloitte & Touche came out with.

Senator REED. What confidence is there in the actuarial review that they did?

Mr. MCCOOL. Well, if they continue to come out with estimates that are close to ours, it gives us more and more confidence.

[Laughter.]

Senator REED. Thank you.

Senator ALLARD. I have a few more questions.

You have noted that in your report, 40 percent of FHA's loans are on new mortgages from 1998 to 1999, and that we have no good data on their performance. Should this concern us? And is it possible that these loans are riskier than other loans in the portfolio?

Mr. MCCOOL. I think, from our perspective, it simply makes us want to be cautious because the portfolio is so loaded toward new loans which we have little experience with.

The question of the relative riskiness again is difficult to know. We have heard a lot about the private sector using technological tools to do a better job of trying to figure out who are the less risky part of the lower end of the mortgage distribution. There may be an attempt by the private sector not so much to harm FHA, but to make money by offering better terms to the less risky part of the low down payment end of the mortgage spectrum. As a result, it could be that FHA is left with a slightly riskier portfolio. We don't

know that. That is again something we will need to keep an eye on as these loans mature.

Senator ALLARD. Is there any information you can give us on the potential for this adverse selection?

Mr. MCCOOL. Whether we have any sense of the magnitude?

Mr. CHERLOW. Right. I would agree with what Mr. McCool said. We probably don't have a good sense now of how large an effect that might be. Unfortunately, we would have a better idea in 2005 what the picture of the Fund at the end of 1999 is, because then you will have data, but that is rather too late to be of a lot of use.

Senator ALLARD. Does your report take into account the January reduction in premiums that was instituted on the Fund by HUD?

Mr. CHERLOW. Not in our estimates because we are just looking at the books of business through 1999 and the premium change applies to new business. But it is certainly one of the factors that we would cite as far as going forward and evaluating the actuarial soundness of the Fund. In our model and Deloitte's, and Price Waterhouse's in the years before, these estimates are not based on new business. They are based on existing business.

Senator ALLARD. Sure.

Mr. CHERLOW. So what happens to new business, of course, is important as well. And with the lower premiums, there is less revenue coming in, obviously, to meet the claims.

Senator ALLARD. How significant a factor do you think the new premiums might be? Can you speculate on that? Minimal? Moderate?

Mr. SCIRE. HUD estimated that over a 6 year period, it would cost \$6 billion.

Senator ALLARD. Yes.

Mr. SCIRE. You might say that estimate is actually conservative because it doesn't take into account any change in risk and volume or demand for FHA's product. And you would expect with a lower insurance premium that they might be able to compete better and therefore, attract less risky business. But their estimate is based upon what the demand for mortgage insurance generally would be in the future.

Senator ALLARD. They were looking at a \$6 billion cost.

Mr. SCIRE. That is right.

Senator ALLARD. Do you know how much of that cost was allocated just this year, for example?

Mr. SCIRE. No, I don't know how much of that would be for this year. I know it was over a 6 year period.

Senator ALLARD. I think that would be interesting. I would be interested if you could make that available, as to how that was allocated out over that time period per year.

Now, your report, then, or the KPMG or the Deloitte & Touche audits factor in the anticipated impact of loss mitigations by FHA. You haven't done that.

Mr. SCIRE. No. HUD estimated that the projected value of the MMI Fund in 2006 would be almost \$6 billion lower given lower premiums that became effective this January. Because this is an estimate for a projected value as of a future date, it cannot be allocated among the intervening years, without establishing projected estimates for those years. Nonetheless, assuming—as FHA does—

that there is no change in the volume and riskiness of loans FHA insures, the difference between the value of the Fund under the previous premium structure and the value under the new premium structure will increase each year in proportion to the volume of business predicted each year because the up-front premium being collected for new loans will be smaller. However, it is possible that the lower cost of FHA mortgage insurance would allow FHA to attract more borrowers and less risky borrowers, which would have a favorable effect on the economic value of the Fund and thereby partially offset the effect of lower up-front premiums. In addition, fewer refunds of up-front premiums are likely given that FHA shortened the period in which the borrowers are eligible for such refunds.

Senator ALLARD. Okay. And there is evidence from most recent KPMG and Deloitte & Touche audits that the FHA Fund is experiencing higher claims and faster prepayments than projected in 1999. In fact, the KPMG audit appears to show that a reestimate of claims and prepayments hurt FHA's bottom line by nearly \$4 billion in fiscal year 2000. Have you taken a look at these numbers and should they concern us?

Mr. SCIRE. Well, I think that that underscores the need for looking at the capital ratio again and again over time, and the caution that we urge in interpreting that having a 2 percent ratio today means that a 2 percent ratio would be sufficient to cover moderately severe conditions regardless of what happens in the future.

So, yes, I think that it is something that would give you cause for concern.

Senator ALLARD. My time has expired.

Senator REED. Go ahead.

Senator ALLARD. I have just a couple more issue areas that I want to cover and then I will be finished.

Senator REED. Fine.

Senator ALLARD. In your report, you state that one could conclude that borrowers during the 1990's overpaid for their insurance. Explain why one might interpret a surplus in FHA's Fund this way.

Mr. MCCOOL. I think it is based on the idea of the MMI Fund being a mutual insurance fund and the extent to which, if you have more than sufficient resources generated to insure, the risks against which you are trying to insure, and there is something left over, then the idea would be, in a mutual insurance fund, you would give some rebates to those people who paid.

Senator ALLARD. Doesn't this argue in favor of a return to distributive shares?

Mr. MCCOOL. Well, again, that is a policy decision. That depends on the total view you have about what the MMI Fund is about and what the FHA is about.

Senator ALLARD. Under the current regulations, when is the Secretary required to reinstitute distributive shares?

Mr. SCIRE. Under current regulations, it establishes two different accounts—a general surplus account and a participating reserve account. The Secretary semiannually is supposed to allocate any profits from the Fund to these two accounts and to do that taking into account the actuarial status of the Fund. And it is from this

participating reserve account that the Secretary makes distributive shares.

I believe the short answer to that question is that the Secretary is supposed to take into account the actuarial status of the Fund before making distributive shares.

Senator ALLARD. Would it be reasonable to conclude that if the Fund is more than 150 percent above the statutorily mandated reserve, that it could be considered actuarially sound, particularly in light of the fact of your previous arguments, the standards for a public fund might be lower than those for a private fund?

Mr. McCOOL. As I think I said before, the actuarial soundness depends on what you want the Fund to be able to withstand. And that is for you in Congress to decide just how much risk you want to be able to withstand.

Senator ALLARD. Are there any other members of the panel that want to make any closing comments?

Senator REED. I have one question, Mr. Chairman.

Senator ALLARD. Let me call on the Ranking Member.

Senator REED. Just one final question. Your analogy to a mutual insurance fund as the measure of whether there is overpayment by premium payers, does that consciously take into consideration the fact that this is a mutual fund that is supported by, essentially, the Federal Government? Does that make a difference in your analogy?

Mr. McCOOL. As I said, it is simply that, when you talk about premiums being overpaid, that is the sense in which they are overpaid. The members of the mutual organization are paying more than is necessary to provide the insurance for themselves. This would mean that they necessarily have to get any amount repaid or a particular amount repaid.

Senator REED. But, conceivably, or hypothetically, this is a mutual organization that would never take place unless it was supported by the Federal Government. So that there is a very large public purpose and public direction here. It is not simply a mutual organization.

Mr. McCOOL. Right.

Senator REED. Thank you.

Senator ALLARD. I want to thank the panel, and I want to thank the Members of the Subcommittee for their questions. I thought this was a very informative hearing.

I am going to adjourn the hearing.

[Whereupon, at 2:03 p.m., the hearing was adjourned.]

[Prepared statements submitted for the record follow:]



**PREPARED STATEMENT OF SENATOR JON S. CORZINE**

Thank you, Mr. Chairman, for holding this hearing and thanks to Mr. McCool for appearing here today to help us understand the General Accounting Office's report on the FHA's Mutual Mortgage Insurance Fund.

I am looking forward to hearing about the GAO's findings with regard to the Fund's 2 percent capital reserve requirement and the Fund's ability to withstand times of economic stress. Given the continuing downturn in economic indicators, I hope we will hear some encouraging news on that front.

Additionally, I am looking forward to discussing, in this or other hearings, the potential for using any excess FHA MMI receipts to promote affordable housing. There is a serious shortage of such housing in many parts of the country, and we need to explore all possible ways to address the problem.

Again, Mr. Chairman, I thank you for holding this hearing and I look forward to hearing from our witness today.

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**PREPARED STATEMENT OF THOMAS J. McCOOL**

MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT  
U.S. GENERAL ACCOUNTING OFFICE

MARCH 19, 2001

Mr. Chairman and Members of the Subcommittee: We are here today to discuss the results of our analysis of the financial health of the Mutual Mortgage Insurance Fund (Fund) of the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Through the Fund, FHA operates a single-family insurance program that helps millions of Americans buy homes. The Fund, which is financed through insurance premiums, has operated without cost to the American taxpayer. Last year, the Fund's economic value appeared to have reached its highest level in at least 20 years—prompting proposals to spend some of the Fund's current resources or reduce net cash flows into the Fund. Concerned about how the soundness of the Fund is measured and proposals to spend what some were calling "excess reserves," you requested that we analyze the financial health of the Fund.

Since 1990 the economic health of the Fund has been assessed by measuring the economic value of the Fund—its capital resources plus the net present value of future cash flows—and the related capital ratio—the economic value as a percent of the Fund's insurance-in-force. For most of its history, the Fund was relatively healthy; however, in fiscal year 1990 the Fund was estimated to have a negative economic value, and its future was in doubt. To help place the Fund on a financially sound basis, Congress enacted legislation in November 1990 that required the Secretary of HUD to, among other things, take steps to achieve a capital ratio of 2 percent by November 2000<sup>1</sup> and to maintain or exceed that ratio at all times thereafter. The legislation also required the Secretary to raise insurance premiums and suspend the rebates, called distributive shares, that FHA borrowers had been eligible to receive under certain circumstances. As a result of the 1990 housing reforms, the Fund must not only meet capital ratio requirements, it must also achieve actuarial soundness; that is, the Fund must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on foreclosed mortgages and administrative costs. However, neither the legislation nor the actuarial profession defines actuarial soundness.

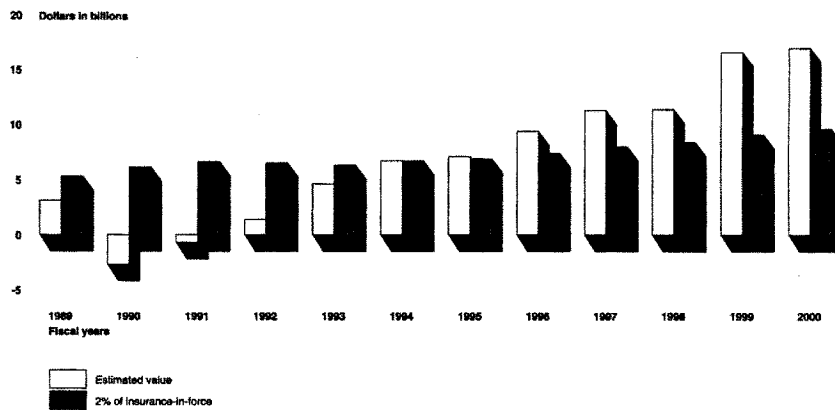
The 1990 FHA reforms required that an independent contractor conduct an annual actuarial review of the Fund. These reviews have shown that during the 1990's, the estimated economic value of the Fund grew substantially. As figure 1 shows, by the end of fiscal year 1995, the Fund attained an estimated economic value that slightly exceeded the amount required for a 2-percent capital ratio. Since that time, the estimated economic value of the Fund continued to grow and always exceeded the amount required for a 2-percent capital ratio. In the most recent review, Deloitte & Touche (Deloitte) estimated the Fund's economic value at about

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<sup>1</sup>The Act defined the capital ratio as the ratio of the Fund's capital, or economic net worth, to its unamortized insurance-in-force. However, the Act defined unamortized insurance-in-force as the remaining obligation on outstanding mortgages—a definition generally understood to apply to amortized insurance-in-force. FHA has calculated the 2-percent capital ratio using unamortized insurance-in-force as it is generally understood—which is the initial amount of mortgages. All capital ratios reported here are measured using unamortized insurance-in-force as it is generally understood.

\$17.0 billion at the end of fiscal year 2000. This represents about 3.51 percent of the Fund's insurance-in-force—well above the required minimum of 2 percent.

**Figure 1: Comparison of Estimated Economic Value and 2 Percent of Insurance-in-Force, 1989-2000**



Source: GAO analysis of Price Waterhouse (now PricewaterhouseCoopers) and Deloitte & Touche data.

Concerned about the adequacy of the minimum 2 percent requirement and about proposals to spend what some were calling excess reserves, you asked us to determine the conditions under which an estimated capital ratio of 2 percent would be adequate to maintain the actuarial soundness of the Fund. Specifically, you asked us to: (1) estimate the value of the Fund at the end of fiscal year 1999, given expected economic conditions, and compare our estimate to the estimate of the value of the Fund reported by HUD for that year; (2) determine the extent to which a 2-percent capital ratio would allow the Fund to withstand worse-than-expected loan performance due to economic and other factors; and (3) describe some options for adjusting the size of the Fund if the estimated capital ratio is different from the amount needed and describe the impact that these options might have on the Fund, FHA mortgagors, and the Federal budget.

In summary:

- We estimate that the Fund had an economic value of about \$15.8 billion at the end of fiscal year 1999. This estimate implies a capital ratio of 3.20 percent of the unamortized insurance-in-force. Although we did not evaluate the quality of the 1999 estimates prepared by Deloitte, using a different method of analysis, we believe that Deloitte's estimates and ours are comparable because of the uncertainty inherent in forecasting and the professional judgments made in this type of analysis. Both of these estimates easily exceed the minimum required capital ratio of 2 percent that Congress set in 1990.
- Given the economic value of the Fund and the state of the economy at the end of fiscal year 1999, a 2-percent capital ratio appears sufficient to withstand moderately severe economic downturns that could lead to worse-than-expected loan performance. That is, under economic scenarios that we developed to represent regional and national economic downturns that the Nation experienced between 1975 and 1999, the estimated capital ratio fell by only slightly less than 0.4 percentage points. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, in three more severe scenarios, an economic value of 2 percent of insurance-in-force would not have been adequate. Nonetheless, because of the nature of such analysis, we urge caution in concluding that the estimated value of the Fund today implies that the Fund would necessarily withstand any particular economic scenario under all circumstances.
- Congress and the Secretary of HUD have taken and could take a number of actions to influence the economic value of the Fund. The impact that these actions have on the capital ratio and FHA borrowers is not always certain. However, actions that influence the Fund's reserve levels will also affect the Federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduc-

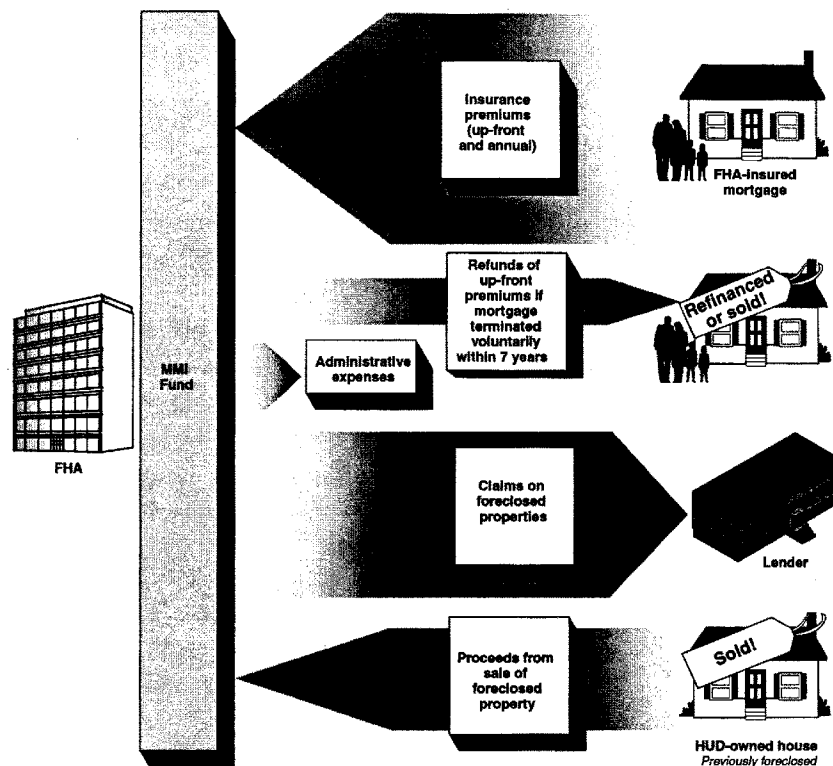
tion in other spending or an increase in receipts, will result in a decline in the Federal budget surplus.

Let me start by describing our estimates of the Fund's economic value and capital ratio and how our estimates compare with estimates prepared by Deloitte & Touche.

#### The Fund's Capital Ratio Exceeds 3 Percent

The economic value of the Fund consists of current capital resources and the net present value of future cash flows. Investments in nonmarketable Treasury securities represent the largest component of FHA's current capital resources. Estimating the net present value of future cash flows is a complex actuarial exercise that requires extensive professional judgment. Cash flows into the Fund from premiums and the sale of foreclosed properties; cash flows out of the Fund to pay claims on foreclosed mortgages, premium refunds, and administrative expenses. (See figure 2.)

Figure 2: Cash Flows of the Mutual Mortgage Insurance Fund



At the end of fiscal year 1999, the Fund had capital resources of \$14.3 billion. Using our models and forecasts of likely values of key economic variables, we estimated that the Fund had a net present value of future cash flows of \$1.5 billion at that time. This yielded an estimated economic value of \$15.8 billion and a capital ratio of 3.20 percent. Given the inherent uncertainty of these estimates and the professional judgments involved, these numbers are comparable to those of Deloitte at the end of 1999, when Deloitte estimated that under expected economic conditions the capital value was \$16.6 billion and the capital ratio was 3.66 percent. Much of the difference seems to be the result of performing the analyses at different times. Because Deloitte performed its analysis before the end of fiscal year 1999, it had to estimate the Fund's capital resources and insurance-in-force, while we were able to use the year-end values. In its recent estimates for 2000, Deloitte noted that in the actuarial review for the fiscal year 1999, it had overestimated the Fund's capital

resources by about \$1 billion. However, Deloitte did not restate the economic value and capital ratio for 1999; instead it adjusted the starting point for the 2000 estimate of economic value. If Deloitte had restated the economic value and capital ratio for fiscal year 1999, the 1999 values would likely have been smaller. Because Deloitte & Touche uses estimates for the Fund's capital resources and insurance-in-force, it is difficult to compare its estimates of the Fund's economic value and capital ratio over time.

**Table 1: Estimates of Capital Ratios for FHA's Mutual Mortgage Insurance Fund by GAO and Deloitte & Touche, End of FY 1999**

Dollars in millions

Estimate	Total capital resources	Future cash flows	Economic value	Unamortized insurance-in-force	Capital ratio (percent)
GAO	\$14,326	\$1,484	\$15,810	\$493,990	3.20
Deloitte	15,331	1,306	16,637	454,184	3.66

Source: GAO analysis and *Actuarial Review of MMI Fund as of FY 1999*, Deloitte & Touche.

The Fund's economic value principally reflects the large amount of capital resources that the Fund has accrued. Because current capital resources are the result of previous cash flows, the robustness of the economy and the higher premium rates throughout most of the 1990's accounted for the accumulation of these substantial capital resources. Good economic times that are accompanied by relatively low interest rates and relatively high levels of employment are usually associated with high levels of mortgage activity and relatively low levels of foreclosure; therefore, cash inflows have been high relative to outflows during this period.

The estimated value of future cash flows also contributed to the strength of the Fund at the end of fiscal 1999. As a result of relatively low interest rates and the robust economy, FHA insured a relatively large number of mortgages in fiscal years 1998 and 1999, and these loans make up a large portion of FHA's insurance-in-force. Because of their low interest rates and because forecasts of economic variables for the near future show house prices rising while unemployment and interest rates remain fairly stable, our models predict that these new loans will have low levels of foreclosure and of prepayment. At the same time, we assume that many FHA-insured homebuyers will continue to pay FHA annual insurance premiums.<sup>2</sup> Thus, our models predict that cash flowing into the Fund from mortgages already in FHA's portfolio at the end of fiscal year 1999 will be more than sufficient to cover the cash outflows associated with these loans.

The future cash flows are estimates based on a number of assumptions about the future, including predictions of mortgage foreclosures and the likelihood that those holding FHA-insured mortgages will prepay their loans. These predictions are based on elaborate models that estimate past relationships between foreclosures and prepayments and certain economic variables, such as changes in house prices. To the extent that these relationships are different in the future, the actual foreclosures and prepayments will differ from the estimates. The estimating procedures make many other assumptions, and I will describe some of these limitations in greater detail later in my testimony.

#### **The Actuarial Soundness of the Fund Depends on the Risks That Congress Wants the Fund to Withstand**

Although our estimates and the Deloitte's estimates of the Fund's capital ratio under expected economic conditions are comparable, we cannot conclude on the basis of these estimates alone that the Fund is actuarially sound. Instead, we be-

<sup>2</sup>Most borrowers with FHA-insured loans who received them prior to September 1983 were required to pay an annual insurance premium for the life of the loan. In addition, most borrowers who received FHA-insured loans after June 1991 are required to pay an annual insurance premium for up to the life of the loan, depending on loan type and the initial loan-to-value ratio of the loan. Borrowers who received FHA-insured loans between September 1983 and June 1991 were not required to pay annual mortgage insurance premiums.

lieve that to determine actuarial soundness one should measure the Fund's ability to withstand certain worse-than-expected conditions. According to our estimates, worse-than-expected loan performance that could be brought on by moderately severe economic conditions would not cause the estimated value of the fund at the end of fiscal year 1999 to decline by more than 2 percent of insurance-in-force. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, a few more severe economic scenarios could result in such poor loan performance that the estimated value of the fund at the end of fiscal year 1999 could decline by more than 2 percent of insurance-in-force.

To help determine the Fund's ability to withstand certain worse-than-expected conditions, we generated economic scenarios that were based on economic events in the last 25 years and other scenarios that could lead to worse-than-expected loan performance in the future. Under each of these scenarios, we used our models to estimate the economic value of the Fund and the related capital ratio. (See table 2.) Most of the scenarios we looked at had only a small impact on the capital ratio. For example, the worst historical scenario we tested, one based on the 1981–1982 national recession, lowered the capital ratio by less than 0.4 percentage points—about 20 percent of the required 2 percent minimum capital ratio. To see how the economic value of the Fund would change as the extent of adversity increased, we extended regional scenarios that were based on historical economic downturns experienced in three States—the west south central downturn based on Louisiana in the late 1980's, the New England downturn based on Massachusetts in the late 1980's and early 1990's, and the Pacific downturn based on California in the 1990's—to the Nation as a whole. In extending the west south central and Pacific downturns, the estimated capital ratio was about 1 percentage point lower than in the base case. However, our models estimate that extending the New England downturn to the country as a whole would reduce the capital ratio by almost 2.4 percentage points. In another scenario, in which we specify that interest rates fall substantially, inducing refinancing, and then a recession sets in, leading to increased foreclosures, the estimated capital ratio fell substantially, by over 1.8 percentage points.

In one other scenario, the capital ratio fell by over 2 percentage points. In that scenario we assumed that foreclosure rates in 2000 through 2004 equal foreclosure rates from 1986 through 1990 for mortgages originated in the 10-year periods prior to 2000 and 1986, respectively.

Table 2: Capital Ratios Under Expected and More Severe Economic Scenarios in Selected Locations

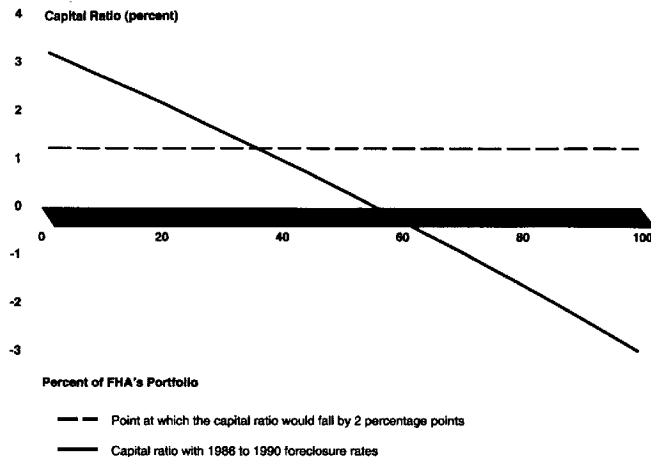
Scenario	Description	Capital ratio for scenarios in one region (percent)	Capital ratio for national scenarios (percent)
Expected economic conditions	Unemployment and interest rates vary as DRI forecasts; house price growth is adjusted for constant quality and slower growth*	NA	3.20
Historical regional downturns			
West south central downturn	House prices and unemployment rates change as they did in Louisiana from 1986 through 1990.	3.06	2.31
New England downturn	House prices and unemployment rates change as they did in Massachusetts from 1988 through 1992.	3.14	0.81
Pacific downturn	House prices and unemployment rates change as they did in California from 1991 through 1995.	2.89	2.16
Other national scenarios			
1981-82 Recession	For each state, house prices, unemployment rates, and interest rates change as they did from 1981 through 1985.	NA	2.81
Induced refinancing followed by a recession	Mortgage interest rates fall, inducing borrowers to refinance, and then a recession sets in, with a rising unemployment rate and falling house prices.	NA	1.37
Rising interest rate scenario	Mortgage and other interest rates from 2000 through 2004 are higher than under expected economic conditions.	NA	3.36
Scenario with foreclosure rates from the 1980s	Foreclosure rates in 2000 through 2004 equal foreclosure rates from 1986 to 1990 for mortgages originated in most recent 10-year period.	NA	0.92

\*Standard and Poor's DRI is a private economic forecasting company.

Source: GAO analysis.

Because none of our economic scenarios generated foreclosure rates as high as those experienced in the west south central states in the late 1980's, we applied these rates directly to our models, assuming that for the next 5 years foreclosure rates in most cases would be equivalent to those experienced by the west south central states in 1986 through 1990. Then we varied the proportion of FHA's portfolio experiencing these west south central foreclosure rates. As figure 3 shows, if about 36 percent of the portfolio experiences these rates, the estimated capital ratio would be 2 percentage points lower than the expected case; and if 55 percent of the portfolio experienced these rates, the economic value of the Fund would fall to zero.

**Figure 3: Capital Ratios Resulting From Applying the Average 1986-90 Foreclosure Rates in the West South Central Census Division to Varying Proportions of FHA's Insurance Portfolio in 2000-04**



Note: West south central mortgages made up 9 percent of FHA's portfolio in 1999. This analysis does not change foreclosure rates for streamline refinanced or adjustable rate mortgages because there are little data on these products for the 10-year period prior to 1986. The west south central Census division includes Arkansas, Louisiana, Oklahoma, and Texas.

Source: GAO analysis.

As we have stated in the past, there is considerable uncertainty associated with any estimate of the economic value of the Fund because of uncertainty about the performance of FHA's loan portfolio over the life of the existing loans, which, in some cases, can be for 30 years. We believe that our models make good use of historical experience in identifying the key factors that influence loan foreclosures and prepayments and estimating the relationships between those factors and loan performance. In addition, we have relied on reasonable, and in some cases conservative, forecasts of economic variables, such as the rate of house price appreciation and the unemployment rate, in finding that the Fund's economic value in fiscal year 1999 appeared higher than necessary to withstand many adverse economic scenarios.

Nonetheless, several additional factors lead us to believe that Congress and others should apply caution in concluding that the estimated value of the Fund today implies that the Fund could withstand the economic scenarios that we examined under all circumstances. Our estimates and those of others are valid only under a certain set of conditions, including that loans FHA insured in recent years and loans it insured in the more distant past have a similar response to economic conditions, and that cash inflows associated with future loans at least offset cash outflows associated with those loans. Some specific factors beyond those incorporated in our models that could determine the extent to which the Fund will be able to withstand adverse economic conditions are as follows:

- **The performance of recent loans**—Over 40 percent of FHA's loan portfolio at the end of fiscal year 1999 consisted of loans originated in fiscal years 1998 and 1999. As a result, the performance of these loans will have an important effect on the overall performance of FHA's loan portfolio. However, because these loans are so new, we do not have a lot of data yet showing how well they will perform

over their lifetimes, which is often 30 years. Our model is based on data on loan performance for loans originating from 1975 through 1999. As long as the influences of key predictive factors on the probabilities of foreclosure and prepayment have not changed much over time, then we can be reasonably confident that the estimates of these relationships generated by our models will apply to these recent loans. However, in recent years, FHA's competitors in the conventional mortgage market—private mortgage insurers and conventional mortgage lenders—are increasingly offering to selected homebuyers products that compete with FHA's for those homebuyers who are borrowing more than 95 percent of the value of their homes. By lowering the required down payment, conventional mortgage lenders and private mortgage insurers may have attracted some less risky borrowers who might otherwise have insured their mortgages with FHA. And this may have increased the average risk of FHA-insured loans in the late 1990's. However, because these loans are relatively new, the increased risk would not yet be observable in the data on foreclosures and prepayments. If this effect, known as adverse selection, has been substantial, the economic value of the Fund may be lower than we estimate, and it may be more difficult for the Fund to withstand worse-than-expected loan performance than our estimates suggest.

- **Changes in FHA's insurance program**—A number of changes that FHA has made or might make in the future could affect the future cash flows associated with loans in FHA's portfolio as of the end of fiscal year 1999 and, therefore, the Fund's economic value, in ways that are not accounted for in our models. For example, if HUD reinstitutes paying distributive shares to borrowers when they pay their mortgages in full or voluntarily terminate their insurance, cash outflows might be higher than our estimates.<sup>3</sup> FHA's loss mitigation program might either reduce or increase cash outflows, depending on whether the program succeeds in reducing foreclosures or whether the program mainly results in delayed foreclosures that lead to larger losses for FHA in the long run. On the other hand, if FHA's financial counseling program reduces foreclosures for those homebuyers who received such counseling, then losses to the Fund will be less than we have estimated. Steps taken by HUD to improve the oversight of lenders and the disposition of properties could also reduce the level of losses to FHA below what we have estimated.
- **The impact of new loans**—Our models do not look at cash flows associated with loans that FHA would insure after fiscal year 1999. Our analysis of the ability of the Fund to withstand adverse economic conditions requires making the assumption that the adverse conditions would not also cause loans insured by FHA after fiscal year 1999 to be an economic drain on the Fund. Since the 1990 FHA reforms, the cash flows associated with each year's loans have been estimated to have a positive economic value, thereby adding to the economic value of the entire Fund. However, during adverse economic times, new loans might perform worse than loans that were insured by FHA during the 1990's. Furthermore, recent and future changes in FHA's insurance program may cause these loans to perform differently from how past experience suggests that they will. If, for example, FHA loosens underwriting standards, future loans may perform worse than past experience suggests. In addition, the recent reduction in up-front premiums could reduce cash inflows into the Fund, although it could also lower the riskiness of the loans that FHA insures. If the newly insured loans perform so poorly that they have a negative economic value, then the loss to the Fund in any of the adverse economic scenarios that we have considered would be greater than what we have estimated. Alternatively, if the newly issued loans have positive economic values, then they would contribute to further growth of the Fund.

Caution also needs to be applied in making changes to FHA's insurance program because of the current uncertainty about their impact on the Fund. In analyzing the impact of changes in FHA's programs and policies on the Fund, it is important to recognize that such changes can affect the volume and riskiness of loans that FHA insures. Although the models currently used in the annual actuarial reviews of the Fund can be used to estimate the direct impact that some policy changes may have on the Fund's economic value, these models cannot isolate indirect effects on the volume and riskiness of FHA's loans. Accordingly, in our report, we recommended that

<sup>3</sup>Between 1943 and 1990, FHA rebated these so-called excess funds to borrowers as distributive shares. In 1990, however, Congress suspended the payment of these shares until the Secretary of HUD determines that the Fund is actuarially sound. HUD has announced that it will resume paying distributive shares. HUD officials said that they are developing systems to facilitate the payment of these shares and expect to be ready to resume paying them in mid-2001.



the Secretary of HUD develop better tools for assessing the impacts that these changes may have on the volume and riskiness of loans that it insures.<sup>4</sup>

**Options for Drawing on the Fund Have Uncertain Outcomes, But Any Use of the Fund's Reserves Will Affect the Federal Budget**

Given the recent growth in the economic value of the Fund, several proposals have been made to use what some are calling excess reserves or take other actions that could result in a change in the value of the Fund. If Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to ensure actuarial soundness, several changes to the FHA single-family loan program could be adopted. The impact that these actions might have on the capital ratio and FHA borrowers is difficult to assess without using tools designed to estimate the multiple impacts that policy changes often have. However, any actions that influence the Fund's reserve levels will also affect the Federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, would result in either a reduction in the surplus or an increase in any existing deficit.

Several changes to the FHA's single-family loan program could be adopted if the Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to meet its definition of actuarial soundness. For example, actions that the Secretary could take that could reduce the value of the Fund include lowering insurance premiums, adjusting underwriting standards, and reinstituting distributive shares. However, Congressional action in the form of new legislation would be required to make other program changes that are not now authorized by the statute. These would include such actions as changing the maximum amount FHA-insured homebuyers may borrow relative to the price of the house they are purchasing and using the Fund's reserves for other Federal programs.<sup>5</sup>

Reliably estimating the potential effect of various options on the Fund's capital ratio and FHA borrowers is difficult because the impacts of these policy changes are complex, and tools available for handling these complexities may not be adequate. Policy changes have not only immediate, straightforward impacts on the Fund and FHA's borrowers, they also have more indirect impacts that may intensify or offset the original effect. Implementing these options could affect both the volume and the average riskiness of loans made, which, in turn, could affect any future estimate of the Fund's economic value. As a result of this complexity, obtaining a reliable estimate would likely require that economic models be used to estimate the indirect effects of policy changes. At this time, however, neither the models used by HUD to assess the financial health of the Fund, nor those used by others, explicitly recognize the indirect effects of policy changes on the volume and the riskiness of FHA's loans. As a result, HUD cannot reliably estimate the impact of policy changes on the Fund.

Although it is difficult to predict the overall impact of a change on the Fund's capital ratio and thus on FHA borrowers as a whole, different options would likely have different impacts on current and prospective FHA-insured borrowers. Some proposals would more likely benefit existing and future FHA-insured borrowers, while others would benefit only future borrowers, and still others would benefit neither of these groups. One interpretation of the higher premiums that borrowers paid during the period in which the economic value of the Fund has been rising is that borrowers during the 1990's "overpaid" for their insurance. Some options for reducing the capital ratio, such as reinstituting distributive shares, would be more likely to compensate these borrowers. The payment of distributive shares would benefit certain existing borrowers who voluntarily terminate their mortgages. If these policies continued into the future, they would also benefit future policyholders. Alternatively, reducing up-front premiums, reducing the number of years over which annual insurance premiums must be paid, or relaxing underwriting standards would tend to benefit only future borrowers.

Under 1990 credit reform legislation, the FHA's budget is required to reflect the subsidy cost to the Government of FHA's loan insurance activities for that year.<sup>6</sup> Credit reform was intended to ensure that the full cost of credit activities for the current budget year would be reflected in the Federal budget so that Congress and the Executive Branch could consider these costs when making annual budget deci-

<sup>4</sup>*Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes* (GAO-01-460, February 28, 2001).

<sup>5</sup>During the 106th Congress, legislation was introduced that proposed using the Fund's resources to fund affordable rental housing. (See S. 2997.)

<sup>6</sup>The subsidy cost is the estimated net cost to the Government, in present value terms, of FHA-insured loans over the entire period the loans are outstanding.

sions. For FHA's Mutual Mortgage Insurance Fund, the subsidy cost is negative; that is, the program is operating at a profit. Under credit reform, the negative subsidy receipts would be available for appropriation for other uses, and a balance would not be permitted to accumulate in the liquidating account. However, to accommodate the differing statutory requirements of budgeting for the subsidy cost of insuring the loans and maintaining a 2-percent reserve, the Office of Management and Budget (OMB) and FHA have allowed reserves to accumulate in the Fund in the form of interest-bearing Treasury securities. At the end of fiscal year 1999, the FHA held nearly \$15 billion in Treasury securities. These securities represent a claim on the U.S. Treasury to cover future losses to the Fund. From the perspective of the U.S. Treasury, these securities represent a liability. From the standpoint of the Government as a whole, the securities represent a debt owed by one part of the Federal Government to another. By investing in nonmarketable Treasury securities, FHA makes funds available to other Federal programs. Each year that the Fund runs a surplus, the budget surplus for the Federal Government, as a whole, is higher than it would otherwise have been if FHA had not been insuring profitable loans. When the total Federal budget was in a deficit (as it was for most of the 1990's), that deficit was lower than it would have been if the Fund had not been realizing a surplus at the same time.

Because of the difficulty in reliably measuring the effect of most actions that could be taken either by Congress or the Secretary of HUD on the Fund's capital ratio, we cannot precisely measure the effect of these policies on the budget. However, any actions taken by Congress or the Secretary that influence the Fund's capital ratio will have a similar effect on the Federal budget. If Congress or the Secretary of HUD adopts policies, such as lowering premiums, paying distributive shares, or loosening underwriting standards, that reduce the profitability of the Fund, the negative subsidy amount reported in FHA's budget submission and the Fund's reserve will both be lower.<sup>7</sup> Some of these policies—lowering premiums and paying distributive shares—would affect FHA's cash flows immediately.<sup>8</sup> Thus, the amount of money available for FHA to invest in Treasury securities would be lower. Treasury in turn would have less money available for other purposes, and the overall surplus would decline. If the amounts of cash flowing out of the Fund exceeded current receipts, FHA would be required to redeem its investments in Treasury securities to make the required payments. Assuming no changes in other spending and taxes, Treasury then would be required to either increase borrowing from the public or use general tax revenues to meet its financial obligations to FHA. In either case, the annual budget surplus would be lower.

Budgetary scoring for budget control purposes under the 1990 Budget Enforcement Act<sup>9</sup> is required only when a law is enacted; actions taken by the Secretary under existing authorities are not scored for budget control purposes, even though they may affect the budget surplus or deficit. Whether and how the proposals under discussion would be scored depend on the exact wording of the new law and is determined by OMB for Budget Enforcement Act purposes. However, any action taken by Congress or the Administration to reduce FHA's reserves, if not accompanied by a similar reduction in other Government spending or by an increase in receipts, will result in either a reduction in the surplus or an increase in any existing deficit.

#### **Actuarial Soundness Should be Defined**

Whether actions should be taken to change the value of the Fund depends on whether the Fund's capital resources and expected revenues exceed the amount needed to meet its expected cash outflows under designated stressful conditions; that is, whether it is actuarially sound. Assessing whether this condition exists requires that the degree of risk that the Fund is expected to be able to withstand must be specified. If the Fund is expected to withstand what Price Waterhouse called reasonably adverse economic downturns, then our results could be construed to mean that the Fund is taking in more revenue than it needs. Alternatively, if the Fund is expected to never exhaust its reserves, the current Fund might not be adequate.

<sup>7</sup>If Congress were to use the Fund's reserves to fund other programs, the reserves would be lower, but there would be no effect on the negative subsidy amount reported in FHA's budget submissions.

<sup>8</sup>Assuming that the volume and the riskiness of FHA-insured loans will not change, HUD estimates that the recent reductions in up-front premiums combined with the introduction of mortgage insurance cancellation policies will lower the estimated value of the Fund by almost \$6 billion over the next 6 years.

<sup>9</sup>As part of the effort to control Federal budget results, the Budget Enforcement Act of 1990, as amended, created controls over laws changing or creating mandatory spending (basically entitlements) and receipts.

The 1990 reforms did not specify the amount of risk that the Fund needed to withstand. Instead, the reforms specified a minimum capital ratio and required that the Fund achieve actuarial soundness before the Secretary of HUD could take certain actions that might reduce the value of the Fund. Because we believe that actuarial soundness depends on a variety of factors that could vary over time, setting a minimum or target capital ratio will not guarantee that the Fund will be actuarially sound over time. For example, if the Fund comprised primarily seasoned loans with known characteristics, a capital ratio below the current 2-percent minimum might be adequate. But under conditions such as those that prevail today, when the Fund is composed of many new loans, a 2-percent ratio might be inadequate if recent and future loans perform considerably worse than expected.

We believe that to evaluate the actuarial soundness of the Fund, one or more scenarios that the Fund is to withstand would need to be specified. Then it would be appropriate to calculate the economic value of the Fund or the capital ratio under the scenario(s). As long as the estimated economic value of the Fund is positive when the desired stress scenario(s) is used to make that estimate, the Fund could be said to be actuarially sound. However, it might be appropriate to leave a cushion to account for the factors not captured by the model and the inherent uncertainty attached to any forecast. In any event, we believe that a single, static capital ratio does not measure actuarial soundness.

#### **Matters for Congressional Consideration**

For these reasons, Mr. Chairman, Congress may wish to consider taking action to specify criteria for determining when the Fund is actuarially sound. More specifically, Congress may want to consider defining the types of economic conditions under which the Fund would be expected to meet its commitments without borrowing from the Treasury.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Subcommittee may have.